United States
Circuit Court of Appeals
For The Ninth Circuit

S. G. ARMSTRONG, F. R. CORNISH, H. HAKES, T. A. TRIMBLE, MARY E. TRIMBLE, HOMER TRIMBLE, HARRY TRIMBLE, CORA T. FAVILLE, F. F. FAVILLE, and SCANDINAVIAN-AMERICAN BANK OF SPOKANE, a corporation,

Appellants,

vs.

UNION TRUST & SAVINGS BANK, a corporation, as Receiver for Fidelity Lumber Company, a corporation,

Appellee.

No. 3009.

Upon Appeal from the United States District Court for the Eastern District of Washington, Northern Division.

Appellee's Brief and Argument

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STATEMENT.

We desire to make one or two comments upon appellants' statement of the case.

The certificates of preferred stock, so called, which are involved in this case, in addition to that portion

quoted in appellants' statement, Page 3, contained the following heading:

"No. 250 ----------Shares

Incorporated under the Laws of the State of Washington

Preferred Certificate of Stock

of

Fidelity Lumber Co.

Capital Stock $1,000,000."

These certificates of stock, as we shall call them, naturally group themselves into three classes and although appellants have discussed the law as applicable generally to the three classes, we believe a clear distinction can and should be made between each class. They are as follows:

1st. Certificates of stock in the form set out at pages 41 and 42 of the transcript, to which no rider or redemption agreement whatsoever was attached; that is to say, the corporation issuing the stock at no time agreed to redeem the same at any definite date.

2nd. Certificates of stock, to which *after issuance* a rider or agreement was attached promising redemption by a certain date. Typical of this form of rider is the one set forth at page 43 of the Transcript. (For examples of this class see Transcript Pgs. 22, 25, 26 and 27, etc.)

3rd. Certificates of stock which *at the time of issuance* had attached thereto a rider similar in form to that above referred to.

ARGUMENT.

A careful reading of appellants' very thorough brief convinces us that they have considered this case on a fundamentally wrong theory; that is to say, they have endeavored to test the rights of the holders of these certificates as *against the corporation* issuing them, without respect to the rights of the *creditors* of that corporation.

This misconception runs through the entire brief; but that the rights of the holders of these certificates should be determined not as against the corporation, but as against the creditors of that corporation represented in this litigation by the Receiver, we think will become apparent from even a casual reading of the cases hereinafter cited.

Appellants are asserting rights against an insolvent corporation in the hands of a Receiver. This Receiver in so far as the present case is concerned, is here representing the creditors and the report and recommendation which the Receiver made to the learned trial court were made not on behalf of the Fidelity Lumber Company, but in the interest of the general creditors, whose undisputed claims would be seriously impaired were the rights of the appellants finally upheld.

Appellants have likewise overlooked this same distinction which the trial court points out in his memorandum opinion, from which we quote:

> "While, therefore, the contracts embodied in the certificates and riders are valid as between stock-holders and as against the corporation, they are void as to creditors, and all obligations of every kind and character arising out of them must be postponed until the claims of general creditors have been satisfied in full." (Trans., Pg. 64.)

We respectfully submit that if a discussion of this case is approached with this distinction clearly in mind, many of the cases cited by appellants as authorities, will quickly be seen to be *not* antagonistic to the position taken by the trial court.

We come then to the consideration of the principal question; as to whether or not the holders of the so-called preferred stock are creditors or stock-holders of the Fidelity Lumber Company.

ELEMENTS OF THE CONTRACT.

In determining this question the court will look to the governing statute, to the resolution under which the preferred shares were issued, to the Articles of Incorporation, to the recitals in the share certificates, and to the riders attached thereto, inasmuch as all these elements enter into and form a part of the contract.

10 *Cyc.* 575;
Spencer vs. Smith, 201 Fed. 647-650.

WEIGHT TO BE GIVEN TO THE DESIGNATION OF THE INSTRUMENT.

While it is true that the court will look to the contract itself to determine whether the holder is a stockholder or creditor, still considerable weight must be given to the designation actually employed by the parties in describing the instrument in question.

Miller vs. Ratterman, 47 Ohio State 141;
Sc. 24 N. E. 496.

In this case the court recognizes the rule that the designation given to the certificate by the parties is not controlling, but said:

> "However, what the parties in a given case have called the subject of the contract is of no little significance in determining their purpose, and when that purpose is certain it is of much importance in giving construction to the contract."

Likewise, in Spencer vs. Smith, *supra.,* the Circuit Court of Appeals for the Eighth Circuit, said:

> "What the parties to a contract may call it, of course, is not binding upon the courts if it is clearly something else. Still in arriving at the intention of the parties we may look to the language which they used in reducing their contract to writing. In the articles of incorporation, in the stock itself, and in the mortgage the stock in controversy is called 'preferred stock'."

THE DESIGNATION AND CHARACTERISTICS OF THE CERTIFICATES IN QUESTION ARE THAT OF STOCK.

We direct the court's attention to the following characteristics and designation in the resolution authorizing the issuance of this stock and in the stock itself, which to our mind characterize it as stock and not as certificates of indebtedness.

1st. By the resolution of the stockholders passed January 25th, 1909 (Trans., Pg. 40), the capital stock of the company was increased from $500,000.00 to $1,000,000.00, of which $200,000.00 was to be preferred stock. The Articles of Incorporation of the company were amended accordingly, so that the increase of capital stock was to be effected by the issuance of $300,000.00 common stock and $200,000.00 *preferred.*

It must be borne in mind that the stock here in controversy is part of the $200,000.00 preferred referred to in this resolution and part of the increased capital of the corporation authorized thereby.

2nd. The resolution repeatedly refers to these certificates as "preferred stock".

3rd. It should be particularly noted that the resolution authorizing the issuance of this stock provides in effect that if the company has been delinquent in the payment of interest for a period of one year, the holder shall be entitled to participate in the conduct of the affairs of the company "in the same manner as the owner of common stock therein".

4th. In the certificate itself are contained all the earmarks of capital stock. In the heading, "Incorporated under the laws of the State of Washington, preferred certificate of stock of Fidelity Lumber Company, capital stock $1,000,000.00" are words which indicate as plainly as words can do, that the certificate represents part of the capital stock. More than this, the certificate is in the usual and customary form of a certificate of stock, outside of the fact that dividends are designated as interest, which circumstance we will comment upon hereafter.

In the view of appellants, these certificates were "a mere convenient method resorted to by this corporation to borrow money and these contracts were issued by the corporation for such loans instead of issuing negotiable promissory notes. They are merely the interest bearing obligations of the corporation and differ little in their legal effect from promissory notes." (Brief, p. 8.)

In making this statement we believe that appellants have entirely overlooked the history and origin of these certificates, and in this connection we call the court's attention to a circumstance of great importance as showing that it was the intention of the corporation to issue stock and not merely a money obligation.

In 1907, the Board of Trustees of the company passed a resolution authorizing an issue of $250,000.00 of *preferred certificates of indebtedness.* These certificates were to bear interest at 7% per annum, payable semi-annually, to run for six years and expressly stip-

ulated that the holders thereof should not be stockholders, but should be creditors. They also provided that the company should have the option of substituting for these certificates of indebtedness, *preferred stock* of the company, with like terms of payment and like conditions. (Trans., Pgs. 39 and 40.)

The preferred stock here in controversy was issued upon the surrender of the preferred certificates of indebtedness, referred to in that resolution.

In the meantime the capital stock of the company had been increased and authority granted for issuing $200,000.00 in preferred stock.

If the preferred stock was never more than a mere money obligation, as counsel for appellants seem to think, then did not the company do a very vain and useless thing when it substituted preferred stock for the preferred certificates of indebtedness? On the other hand, does not the very fact that preferred certificates of indebtedness were first issued, expressly stipulating that the holder should be a creditor and not a stockholder, and that these certificates of indebtedness were later converted into preferred stock, point almost conclusively to the conclusion that both the company itself and the persons with whom it was dealing, understood that they were receiving stock, and not a mere money obligation? Else why the change?

Appellants have urged at considerable length that the company and the holders of these certificates, both dealt with them as certificates of indebtedness, and not as

certificates of stock, and that inasmuch as the construction which the parties themselves placed upon the contract is of great weight, this should impel the court to hold that the owners of these certificates are creditors and not stockholders.

Here again we find the fundamental error into which appellants have fallen in trying to test these certificates without reference to the rights of creditors. Under the trust fund doctrine of the capital stock of a corporation, which is now almost universally accepted, there are three parties concerned with a corporation's capital stock;—the stockholder, the company and the company's creditors. Hence it must be apparent that even if the company here and the holders of these certificates did in fact construe them to be certificates of indebtedness (which we emphatically deny) still such construction certainly would not be binding upon the other party to the contract, to-wit:—the company's creditors.

But as above indicated, the fact that the company issued this preferred stock in substitution and exchange for certificates of indebtedness, shows that the parties did not regard the certificates in question as mere certificates of indebtedness Again the fact that the right to vote was granted after the company became delinquent one year upon these certificates, is important, because surely even the average man must understand that the only thing that is voted in a company is stock, and that mere money obligations of a corporation do not carry with them the right to vote.

LEGAL STATUS OF THE CERTIFICATES IN QUESTION.

We believe that the court will find no difficulty in deciding that these certificates were certificates of stock.

The only question then which remains is whether or not the promise on the part of the Fidelity Lumber Company to redeem this stock at a certain date, which was attached to the certificates in the form of a rider, gave to the holder not only the rights of a stockholder, but also those of a creditor of the company.

We have made a very thorough examination of the authorities and while a few of the earlier cases were inclined to hold that certificates similar to those involved in this case, and with promises of redemption at a certain date, were certificates of indebtedness and not stock, yet we believe that all of the recent cases and to our mind the best considered cases support the position of the trial court.

We submit that the reasoning in these cases is unanswerable and will appeal to your Honors.

One of the leading cases on the subject and one referred to in nearly all of the decisions, is the case of

Hamlin vs. Toledo S. T. & K. C. R. Co., 78 Fed. 664,

decided in 1897.

The opinion in this case was written by Judge Lurton and concurred in by Judge Taft. We ask the court to read this case. The pith of the decision may be

gathered from the following quotation from the opinion:

> "If the purpose of providing for these peculiar shares was to arrange matters so that under any circumstances a part of the principal of the stock might be withdrawn before the full discharge of all corporate debts, the device would be contrary to the nature of capital stock, opposed to public policy, and void as to creditors affected thereby."

Rider vs. John G. Delker & Sons Co., 140 S. W. 1011 (Ky.)
Sc. 39 L. R. A. Ns. 1007,
decided in 1911.

In this case the preferred stock contained a provision giving the holder the right to have his certificate redeemed at any time after five years by giving six months previous notice. The plaintiff brought suit upon five shares of this stock to recover the par value, alleging that the notice required by the Articles of Incorporation and the terms of the stock itself had been given. The case clearly raises the question as to whether or not the holder was a stockholder or creditor of the company. The court in holding that the certificates constituted the holder a stockholder and not a creditor, said:

> "The capital of the corporation is the sum total of its stock, whether common or preferred. Certificates of stock are mere evidences that the holders thereof have invested the sums called for in the certificates in the enterprise. They run the risk of losing their stock if the business is not a success. As between themselves and third persons who deal with the corporation and give it credit, their stock is equally liable. It is only in cases

> where the corporation is solvent and the rights of creditors not injuriously affected thereby that agreements as to preference among themselves, may be enforced. The entire capital, without regard to any arrangement which may exist between common and preferred stockholders, is at all times subjcet to and liable for the debts of the corporation, and no part of the capital can be withdrawn from the business until the debts of the corporation are satisfied."

Warren vs. Queen, 87 Atl. 595 (Pa.), decided in 1913.

This was an action brought to recover upon a certificate of preferred stock which after guaranteeing the payment of 8% dividends annually out of the earnings of the company contained the following stipulation:

> "The shares represented by this certificate shall be redeemed by the company on March 1st, 1911, at par."

The question therefore was clearly raised as to whether the stock constituted the holder a creditor or stockholder. The court, after holding that the certificate in form and substance evidenced the ownership of fifty shares of preferred stock and could not be construed to be a contract for the payment of money, said:

> "It would be against public policy to permit a preferred stockholder to assert his claim as such against the funds of a corporation in preference to the claims of creditors. The stock of a corporation is its capital, and is responsive to the claims of its creditors. It is held in trust for the payment of the indebtedness of the corporation. The relation of a stockholder and a creditor of a cor-

> poration is not at all alike, but entirely different. A certificate of stock does not make the holder a creditor as well as a stockholder. A stockholder cannot be both a creditor and a debtor by virtue of his ownership of stock. The stock is part of the capital of the corporation which the holder cannot withdraw until its indebtedness is paid. * *
>
> A corporation has no right to make any rules by which the holder of stock, common or preferred, may be preferred in the liquidation of its assets over the creditors of the company."

Inscho vs. Mid-Continent Development Co., 146 Pac. 1014 (Kan.),
decided in 1915.

In this case the stock was preferred as to dividends and assets upon a winding up of the company's affairs. It was not entitled to vote and was redeemable at the option of the company after one year from date of issue. The Company through its Board of Directors passed a resolution exercising its option to redeem the stock in question and obligated itself to redeem the same. Thereafter the holder of the stock brought suit to recover its par value, etc. The court after a very full review of the authorities held that the certificates were stock and not certificates of indebtedness. The court carefully distinguishes the older cases cited in 10 Cyc. 574.

Warren vs. King, 108 U. S. 389;
Sc. 27 L. Ed. 769.

The Supreme Court of the United States in construing a certificate of preferred stock containing a stipulation that same should be a lien upon the assets

of the company after the indebtedness held that the holder was a stockholder and not a creditor.

Spencer vs. Smith, 201 Fed. 647,
decided in 1912.

This case, decided by the Circuit Court of Appeals for the Eighth Circuit, reverses a case sometimes referred to in support of the contrary doctrine, namely: *In re* 50 Gold Mines Corporation, 190 Fed. 105. The certificate involved in this case contained the following stipulation:

> "Said corporation expressly agrees to redeem all its preferred stock on or before January 1st, 1916."

In addition, the company executed a deed of trust or mortgage to secure the payment of dividends, and the redemption of the stock as stipulated. The court held that this was not a certificate of indebtedness but constituted the owner a stockholder of the company. We ask the court to read this case. We do not believe that appellants have distinguished this case from the one at bar. It is stronger if anything, in that the company executed a trust deed or mortgage expressly guaranteeing the redemption of the stock and we believe that this court, as did the trial court, will find that the differences between the certificates here in controversy and the certificates of stock in the Spencer case, are slight and unimportant.

For a very general discussion of this proposition see subject "Corporations", 7 R. C. L. Sec. 171. Thompson on Corporations, 2nd Ed., Vol. 4, Sect. 3607.

Appellants urge very earnestly that Sections 3677 and 3697, R. & B. Anno. Codes and Statutes, referred to in the opinion of the trial court, have no application to the situation in this case. For the court's convenience we quote Sect. 3697 R. & B. Codes:

> "It shall not be lawful for the trustees to make any dividend except from the net profits arising from the business of the corporation, nor divide, withdraw or in any way pay to the stockholders, or any of them, any part of the capital stock of the company, nor to reduce the capital stock of the company, unless in the manner prescribed in this chapter, or the Articles of Incorporation or by-laws. * * *"

The position of appellants as we understand it is that the issuance of this stock with the rider attached, promising redemption by a certain date, was no more nor less than the sale of the stock with a contemporaneous agreement on the part of the company to repurchase the same at a certain time, and cases are cited by appellants to the effect that as between the company and a stockholder buying under such an agreement for repurchase, the transaction is not within the inhibition of such a statute as we have quoted above.

Again we say that appellants have overlooked the distinction which obtains where the rights of creditors are involved

The cases cited by appellants are all cases between corporations and a stockholder, and the courts are very careful to point out that a different rule obtains where the rights of creditors are affected. As illustrative of

this distinction, see

> *Schulte vs. Boulevard Gardens Land Co.,* 164 Cal. 464; Sc. 129 Pac. 582; Sc. 44 L. R. A. NS. 156.

The case cited involved the construction of a contract executed in connection with the issuance of certain stock whereby the corporation in effect promised to repurchase the stock upon ninety days' notice. After holding that the contract did not violate the provision of the California Code, very similar to that in force in Washington quoted above, the court said:

> "All that has been said is subject to the qualification that the rights of creditors are not to be affected by the arrangement between the purchasers of stock and the corporation. No doubt a creditor of the corporation would be entitled to hold the conditional purchaser as a stockholder and to insist that the amount of his subscriptions be made applicable to the satisfaction of the corporate debts. In most of the cases cited by respondent the courts were dealing with states of facts in which the rights of creditors were involved. But no such question arises here; the complaint alleging that the assets of the corporation are greatly in excess of its indebtedness."

This corporation has held itself out to the world as a company possessed of a capital stock of $1,000,000.00. It issued these certificates under the designation of stock and as part of its capital of $1,000,000.00. The holder was entitled to vote after one year's delinquency in the payment of interest. Doubtless also the holder was entitled to participate in the profits, if any, of the company. To permit the holders of this stock to withdraw the par value thereof to the injury of creditors,

is to permit the holders to practice a constructive fraud upon those who have dealt with the company on the faith of its having a capital of $1,000,000.00. It seems to us that the riders attached to this stock promising redemption on a certain date are therefore contrary to public policy and void, and that the holders of this stock are in no sense creditors, and can only share in the assets of the corporation after the creditors of the company have been paid in full.

Appellants urge that because the certificates in question promise the payment of interest, that that determines their status as money obligations. We might very well suggest the rule referred to by counsel that what parties term a thing does not necessarily determine its legal status. Whether it be termed interest or dividends, the guarantee of the company to pay the same irrespective of the earnings of the corporation would be illegal as against creditors. As between the company and the holder of the certificate the guarantee might be enforcable.

Viewed from the standpoint of the rights of creditors in this case, the holders of the certificates in question were clearly stockholders under the authorities which we have cited, and if they are to be regarded as creditors in any sense, their rights as suggested by the learned trial court must be postponed until the ordinary obligations of the company have been liquidated.

The judgment should be affirmed.

Respectfully submitted,

HAMBLEN & GILBERT,

Solicitors for Appellee.